

***United States Court of Appeals
for the Second Circuit***



APPELLEE'S BRIEF

ORIGINAL

77-5036

To be submitted by
ARTHUR S. OLICK

In The
United States Court of Appeals
For The Second Circuit

In Re
EASTERN FREIGHT WAYS, INC.,
Bankrupt,

SIDNEY B. GLUCK, Trustee in Bankruptcy of EASTERN
FREIGHT WAYS, INC.,

Plaintiff-Appellee.

-against-

SEABOARD SURETY COMPANY,
Defendant-Appellant,

MANUFACTURERS HANOVER TRUST COMPANY,
individually and as agent for other institutional lenders,
INTERNATIONAL HARVESTER CREDIT
CORPORATION, FRUEHAUF CORPORATION and THE
CHASE MANHATTAN BANK, NATIONAL
ASSOCIATION, and THOMAS J. CAHILL, Trustee
in Bankruptcy of ASSOCIATED TRANSPORT, INC.,

Defendants-Appellees.

*On Appeal from the United States District Court for the
Southern District of New York*

**BRIEF FOR DEFENDANT-APPELLEE, THOMAS J.
CAHILL, TRUSTEE IN BANKRUPTCY OF ASSOCIATED
TRANSPORT, INC.**

ANDERSON RUSSELL KILL & OLICK, P.C.

Attorneys for Defendant-Appellee

Thomas J. Cahill, Trustee in

Bankruptcy of Associated Transport, Inc.

630 Fifth Avenue

New York, New York 10020

(212) 397-9700

ARTHUR S. OLICK

POPPY B. QUATTLEBAUM

Of Counsel

LUTZ APPELLATE PRINTERS, INC.

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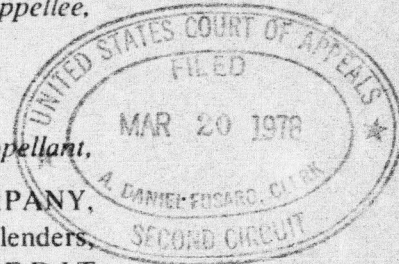


TABLE OF CONTENTS

	<u>Page</u>
Preliminary Statement	2
Questions Presented	2
Statement of the Case	4
Statement of Facts.	6
 ARGUMENT:	
POINT I - THE BANKRUPTCY COURT HAS JURISDICTION TO DETERMINE THE COMPETING CLAIMS TO THE CHASE LETTER OF CREDIT	10
POINT II - SEABOARD, AS SURETY, MAY NOT ASSERT ANY RIGHT OF SET OFF UNLESS AND UNTIL THE PROCEEDS OF THE LETTER OF CREDIT ARE EXHAUSTED	15
Conclusion.	20

TABLE OF AUTHORITIES

	<u>Page</u>
<u>Cases:</u>	
<u>In re Dolly Madison Industries, Inc.,</u> 326 F.Supp. 441 (E.D.Pa. 1971)	11, 14
<u>James Talcott, Inc. v. Glavin,</u> 104 F.2d 851 (3d Cir.), <u>cert. denied</u> 308 U.S. 598 (1939)	11, 14
<u>Law Research Service Inc. v. Crook,</u> 524 F.2d 301 (2d Cir. 1975)	14
<u>In re Lea Fabrics, Inc.,</u> 226 F.Supp. 232 (D.N.J. 1964).	14
<u>MacDonald v. Plymouth County Trust Co.,</u> 286 U.S. 263 (1932).	10
<u>Meeker v. Halsey,</u> 87 F.2d 299 (2d Cir. 1937).	17
<u>Thompson v. Magnolia Petroleum Co.,</u> 309 U.S. 478 (1940).	10
<u>United States ex rel Johnson v. Morley</u> <u>Construction Co.,</u> 98 F.2d 781 (2d Cir. 1938)	16, 17
<u>In re Yale Express System, Inc.,</u> 362 F.2d 111 (2d Cir. 1966)	15, 16, 17, 18, 19
<u>Statutes and Rules:</u>	
<u>Bankruptcy Act:</u>	
Section 2, [11 U.S.C. §11]	10
Section 23, [11 U.S.C. §46].	10
Section 68(a), [11 U.S.C. §108(a)]	17
Section 70(a), [11 U.S.C. §110(a)]	10
<u>Other Authority:</u>	
1 Collier on Bankruptcy, §2.06 (14th Ed. 1974). . .	11
2 Collier on Bankruptcy, §23.04[2] (14th Ed. 1976).	11
2 Collier on Bankruptcy, §23.05[4](14th Ed. 1976).	10

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HARVESTER CREDIT CORPORATION, FRUEHAUF
CORPORATION and THE CHASE MANHATTAN
BANK, NATIONAL ASSOCIATION, and THOMAS
J. CAHILL, Trustee in Bankruptcy of
ASSOCIATED TRANSPORT, INC.,

Defendants-Appellees.

ON APPEAL FROM THE UNITED STATES
DISTRICT COURT FOR THE SOUTHERN
DISTRICT OF NEW YORK

- - - - - x

BRIEF OF DEFENDANT-APPELLEE
THOMAS J. CAHILL, TRUSTEE IN
BANKRUPTCY OF ASSOCIATED
TRANSPORT, INC.

To be submitted by

Arthur S. Olick

UNITED STATES COURT OF APPEALS
FOR THE SECOND CIRCUIT

- - - - - X

In Re :

EASTERN FREIGHT WAYS, INC., :

Bankrupt. :

- - - - - X

SIDNEY B. GLUCK, Trustee in Bankruptcy :
of Eastern Freight Ways, Inc., :

In Bankruptcy
No. 76-B-981

Plaintiff-Appellee, :

-against- :

SEABOARD SURETY COMPANY, :

proceeds of a certain letter of credit issued in Seaboard's favor by the Chase Manhattan Bank, N.A. ("Chase"). This brief is submitted on behalf of the Trustee of Associated who supports the decision of the Bankruptcy Court (531a) in its entirety.

Questions Presented

There are but two issues properly presented to this Court for determination:

1. Does the Bankruptcy Court have the requisite

* References are to the pages of the Joint Appendix denominated by appellant without consultation with the appellees.

Preliminary Statement

Seaboard Surety Company ("Seaboard") appeals to this Court from an order (662a)* of the United States District Court for the Southern District of New York (Palmieri, J.) affirming an order (543a) of the Bankruptcy Court (Babitt, J.) enjoining it, pendente lite, from encouraging account debtors to set off their debts to the bankrupt estate of Eastern Freight Ways, Inc. ("Eastern") against their cargo claims against Eastern for which Seaboard stands as surety and directing an evidentiary hearing with respect to the proper allocation as between Eastern and the bankrupt estate of Associated Transport, Inc. ("Associated") of the

summary jurisdiction to determine the respective claims of Eastern, Associated and Seaboard in and to a certain letter of credit issued in Seaboard's favor by Chase?

[The District Court held that the Bankruptcy Court had jurisdiction over the proper application of the proceeds of the letter of credit].

2. Must Seaboard, as surety, account for and exhaust the proceeds of the letter of credit before it can assert any equitable right to encourage Eastern's customers to set off their claims for cargo loss and damage against amounts owed by such customers to Eastern for freight charges?

[The District Court held that any right to the benefit of set offs which may accrue to Seaboard as surety does not arise unless and until Seaboard has accounted for and exhausted the proceeds of the letter of credit].

Statement of the Case

This adversary proceeding was instituted by Eastern's Trustee for a declaratory judgment and injunction to prevent Seaboard from interfering with his collection of accounts receivable by urging Eastern's customers to set off their cargo damage claims against monies owed to Eastern for transportation services rendered (257a). Manufacturers Hanover Trust Company ("Manufacturers"), International Harvester Credit Corporation ("Harvester"), Fruehauf Corporation, ("Fruehauf") and Chase were joined by Eastern's Trustee as secured creditors having interests in Eastern's receivables and essentially support his position (304a, 277a, 336a, 340a). The Trustee of Associated was joined as an adverse claimant to the proceeds of a Chase letter of credit drawn upon by Seaboard upon the advent of the bankruptcy and applied by Seaboard to cargo damage claims asserted against both Eastern and Associated (266a). The Associated Trustee supports the claim against Seaboard except that Associated's Trustee is allied with Seaboard with respect to the disposition of the proceeds of the letter of credit. Associated's Trustee joined with the other defendant-appellees in resisting Seaboard's claim to the benefits of set off but supported Seaboard to the extent of claiming that the proceeds of the subject letter of credit belonged to both bankrupt estates and not solely to Eastern (394a).

Seaboard moved to dismiss the complaint on the grounds that (a) the Bankruptcy Court lacked subject matter jurisdiction over the proceeds of the letter of credit and (b) the complaint failed to state claims upon which relief could be granted (371a). The Bankruptcy Court sustained Seaboard's motion respecting Eastern's Trustee's claim of conversion [the second cause of action] but otherwise sustained his complaint as a matter of law (543a). Significantly, the Bankruptcy Court declined to rule on the merits of Eastern's claim [first cause of action] that the prior assignment by Eastern of its accounts receivable defeated any rights that Seaboard, as surety, might otherwise have to take advantage of set offs (537a). Rather, the Bankruptcy Court held that, as a matter of law, Seaboard had no recourse against Eastern until it could demonstrate that the proceeds of the letter of credit had been exhausted (538a-541a). In consequence, the Bankruptcy Court granted Eastern a declaratory judgment to that effect, preliminarily enjoined Seaboard from asserting any set off right and directed an evidentiary hearing "on the proper allocation between the Trustees [of Eastern and Associated] of the letter of credit, and the reach of the contract between Seaboard and both Eastern and Associated" (542a).

Seaboard appealed to the District Court which sustained the Bankruptcy Court in all respects (662a).

Statement of Facts

Both Eastern and Associated were licensed common carriers in the trucking business under the regulatory jurisdiction of the Interstate Commerce Commission ("ICC"). Eastern and Associated were authorized by ICC regulation to act as self-insurers for cargo losses sustained by their respective shipping customers (261a).

By August 1974, Eastern had acquired approximately 46% of the issued and outstanding shares of stock of Associated and, upon authorization of the ICC, was operating and managing the affairs of Associated. Prior to 1974, Seaboard had executed on Associated's behalf and in connection with its self-insurance program surety bonds for a variety of purposes including cargo loss and damage claims. These bonds were secured by collateral in the approximate amount of \$600,000 (354a).

After Eastern gained control of Associated in 1974, Seaboard was asked to expand its self-insurance program for Associated to include suretyship on a combined basis for Eastern as well as Associated, effective September 1, 1974 (355a). Pursuant to that request, on August 26, 1974, Eastern and Associated executed and delivered to Seaboard a "Collateral Agreement" under which Eastern and Associated agreed to provide collateral for Seaboard's exposure under any bonds issued on behalf of Eastern or Associated (359a).

Eastern and Associated also executed and delivered to Seaboard on September 16, 1974 a "General Agreement of Indemnity" pursuant to which Eastern and Associated agreed, jointly and severally, to indemnify Seaboard against the obligations of either under any surety bonds issued by Seaboard (363a). In further connection with this request, on September 12, 1974, Chase issued a letter of credit in the amount of \$2,000,000 for the account of Eastern and to the benefit of Seaboard (269a). Finally, upon receipt of the executed collateral and indemnity agreements, Seaboard released the \$600,000 of Associated collateral then held, and substituted therefor the new collateral consisting of the \$2,000,000 Chase letter of credit (355a-356a).

On April 22, 1976, Eastern and Associated each filed a petition for an arrangement under Chapter XI of the Bankruptcy Act and each was subsequently adjudicated a bankrupt on April 28, 1976 (1a, 2a, 258a). On June 8, 1976 Thomas J. Cahill was duly appointed Trustee in Bankruptcy of Associated (258a). Eastern, after filing a second arrangement petition and operating its business as a debtor in possession, was again adjudicated a bankrupt on August 25, 1976, and Sidney B. Gluck was duly appointed Trustee in Bankruptcy of Eastern (258a, 259a).

On April 28, 1976, the date on which both companies were adjudicated bankrupt, Seaboard, upon delivery of the requisite certification to Chase, took down the proceeds of

the \$2,000,000 letter of credit (266a, 357a). Upon obtaining possession of the proceeds, Seaboard began to utilize the monies to satisfy certain claims submitted on the bonds written by Seaboard for both Eastern and Associated (357a-358a). At issue in this case, inter alia, is the question whether the proceeds of the Chase letter of credit may properly be used by Seaboard to satisfy claims on the bonds written for Associated as well as claims on the bonds written for Eastern.

Upon receipt of the proceeds of the letter of credit, Seaboard began sending letters to certain of Eastern's and Associated's shipper-customers advising them that they should deduct sums owed to Eastern or Associated for freight charges ("accounts receivable") from cargo claims asserted by the shipper-customers against Eastern or Associated and that Seaboard would not be responsible for more than the difference between the two amounts (264a-265a, 271a). The question of whether Seaboard may solicit and require set off by shipper-customers of Eastern is also at issue in this litigation.

At the time that Eastern and Associated were adjudicated bankrupts, there were approximately 20,000 unpaid cargo claims outstanding, many of which were asserted by shipper-customers who also owed freight charges to the two trucking companies. Seaboard has indicated in these proceedings that total payments on outstanding cargo and

other claims made pursuant to surety bonds issued on behalf of Eastern and Associated will far exceed in amount the proceeds of the \$2,000,000 letter of credit (358a). Naturally, the allocation of such proceeds as between the two bankrupt estates significantly impacts their respective administrations and the rights of their respective creditors.

After Eastern and Associated had entered into the joint bonding program with Seaboard, but prior to the filing of the petitions in bankruptcy, Eastern also entered into various security agreements with Manufacturers, Harvester, and Fruehauf, assigning to those companies interests in Eastern's accounts receivable as security for loans and advances made to Eastern (260a-261a). Eastern further assigned all of its operating rights as additional security to Manufacturers (261a). At all times relevant to these proceedings the accounts receivable of Associated were assigned to the Berkeley Service Corporation ("Berkeley") as security for loans and advances made to Associated.

POINT I

THE BANKRUPTCY COURT HAS JURIS-
DICTION TO DETERMINE THE COMPETING
CLAIMS TO THE CHASE LETTER OF CREDIT

A bankruptcy court may exercise summary jurisdiction respecting competing claims to property in its actual or constructive possession. Bankruptcy Act §§2, 23, [11 U.S.C. §§11, 46]; Thompson v. Magnolia Petroleum Co., 309 U.S. 478, 481 (1940). It also has jurisdiction to determine competing claims to property where there is consent, actual or implied, on the part of the respective claimants. MacDonald v. Plymouth County Trust Co., 286 U.S. 263 (1932). Here, there is both possession and consent such that the assertion of jurisdiction by the Bankruptcy Court was entirely proper.

The gravamen of the dispute between Seaboard and the bankrupt estates of Eastern and Associated and their respective creditors involves the disposition of the bankrupts' accounts receivable. It is beyond peradventure that these accounts receivable are in the constructive possession of the Bankruptcy Court pursuant to Section 70(a) of the Bankruptcy Act [11 U.S.C. §110(a)]. See, 2 Collier on Bankruptcy, §23.05[4] (14th Ed. 1976). Accordingly, Section 2 of the Bankruptcy Act grants the Bankruptcy Court exclusive jurisdiction to determine all rights with respect to Eastern's accounts receivable, including, most specifically, Seaboard's

claim that it may take advantage of those accounts receivable by way of set off against cargo damage claims against Eastern for which it stands as surety.

If the Bankruptcy Court was correct in its determination that the disposition of the proceeds of the letter of credit is inextricably bound to the determination of Seaboard's claim of set off respecting Eastern's accounts receivable then the assertion of jurisdiction to which Seaboard takes exception is manifestly proper since a bankruptcy court may properly determine all competing claims connected with the underlying transaction over which it has undisputed jurisdiction. James Talcott, Inc. v. Glavin, 104 Fed.2d 851 (3d Cir.), cert. denied, 308 U.S. 598 (1939); In re Dolly Madison Industries, Inc., 326 F.Supp. 441, 444 (E.D.Pa. 1971). The summary jurisdiction of a bankruptcy court respecting property in its possession extends to all interests affecting the estate and all rights and claims pertaining to that property. 1 Collier on Bankruptcy §2.06 (14th Ed. 1974); 2 Collier on Bankruptcy, §23.04[2] (14th Ed. 1976). An examination of the pleadings establishes conclusively the close connection between the accounts receivable in the Bankruptcy Court's possession and the proceeds of the letter of credit on the basis of which the Bankruptcy Court asserted jurisdiction. The Eastern Trustee's first cause of action seeks a declaratory judgment to the effect that Seaboard does not have a right to set off or

cause to be set off accounts receivable owed to Eastern against cargo claims for which Seaboard stands as surety. In its motion to dismiss, Seaboard asserted that its right to set off the accounts receivable was unlimited as a matter of law. The Bankruptcy Court refused to recognize Seaboard's claim of unlimited right to set off but, rather, held that any right Seaboard might have did not arise or ripen until the proceeds of the letter of credit were exhausted. The District Court agreed.

Since there are clearly disputed issues of fact respecting Seaboard's disposition of the proceeds of the letter of credit and a dispute between Eastern and Associated as to the allocation of such proceeds summary disposition was impossible and an evidentiary hearing required. For the Bankruptcy Court to have declined jurisdiction over the factual dispute which must be resolved as a first step in determining the rights of the various interested parties in the accounts receivable would have been illogical and manifestly inequitable. Certainly Seaboard cannot be serious in contending that the Bankruptcy Court should simply deny its motion to dismiss, grant a preliminary injunction and wait for the respective parties, at their leisure and in their discretion, to proceed in a separate forum to resolve the factual disputes respecting the proceeds of the letter of credit. As the Bankruptcy Court correctly observed:

"It would represent an unwarranted effusion of judicial and litigants' time and energies for this court to deal with the set offs solicited by Seaboard against the trustee's assets... clearly within this court's jurisdiction at least as between Seaboard and the trustee and then send the trustee elsewhere to litigate as to the letter of credit" (538a).

Assuming, arguendo, that the Bankruptcy Court might not otherwise have jurisdiction over the competing claims to the proceeds of the letter of credit, jurisdiction in this case was properly asserted by reason of Seaboard's "consent" which it is now estopped from denying. By demanding declaratory relief in its favor in the adversary proceeding instituted by the Eastern Trustee, Seaboard has placed itself within the jurisdiction of the Bankruptcy Court for all purposes incident to the issues thus raised. It must be noted that Seaboard's response to the complaint of the Eastern Trustee was not a simple demurrer. Rather, Seaboard sought affirmatively a declaratory judgment in its favor establishing its alleged equitable right through set off to the accounts receivable within the Court's jurisdiction. Having taken this decisive step it may not now equivocate. As the Bankruptcy Court correctly held:

"By proceeding on the merits of the asserted right to set offs, an issue inextricably intertwined with the existence of the proceeds of the letter of credit, Seaboard has consented to the court's jurisdiction. 2 Collier on Bankruptcy (14th Ed. §23.08(5))" (538a).

It is well settled that when a party consents to the adjudication of an issue, claim or interest, it consents

to the Bankruptcy Court's summary jurisdiction as to all aspects of the issue thus raised. In re Dolly Madison Industries, Inc., 326 F.Supp. 441 (E.D.Pa. 1971). Once summary jurisdiction properly attaches the Bankruptcy Court may properly determine the rights of all parties in connection with the subject matter to which jurisdiction has attached. James Talcott, Inc. v. Glavin, 104 F.2d 851 (3d Cir.), cert. denied, 308 U.S. 598 (1939); In re Lea Fabrics, Inc., 226 F.Supp. 232 (D.N.J. 1964).

As the District Court observed: "[I]t is not necessary to resolve the arguments asserting and denying the existence of an independent basis for jurisdiction to sustain the Bankruptcy Judge's decision to determine the proper use and application of the proceeds of the letter of credit" (672a). Assuming, arguendo, that Seaboard's rights to set off depend upon the use and application of the proceeds of the letter of credit, jurisdiction to determine set off necessarily embraces jurisdiction to determine use and applicaton. The issues are interdependent or "inextricably intertwined" such that the Bankruptcy Court's clear jurisdiction over the one gives it ancillary jurisdiction over the other. James Talcott, Inc. v. Glavin, 104 F.2d 851, 853 (3d Cir.), cert. denied, 308 U.S. 598 (1939); Law Research Service, Inc. v. Crook, 524 F.2d 301, 313-15 (2d Cir. 1975).

POINT II

SEABOARD, AS SURETY, MAY NOT
ASSERT ANY RIGHT OF SET OFF
UNLESS AND UNTIL THE PROCEEDS
OF THE LETTER OF CREDIT ARE
EXHAUSTED

Seaboard relies upon the decision of this Court in In re Yale Express System, Inc., 362 F.2d 111 (2d Cir. 1966) for the proposition that it has an absolute right to set off accounts receivable against cargo claims. Eastern's Trustee, Eastern's various secured creditors, and the Associated Trustee assert a variety of distinctions between this case and the situation presented in Yale Express. The Bankruptcy Court did not rule on any of the distinctions raised except for the claim relating to the letter of credit. The Bankruptcy Court held that, as a matter of law, there could be no right of set off in favor of the surety "until the proceeds of the letter of credit are exhausted" (541a). Accordingly, the Bankruptcy Court directed an evidentiary hearing "on the proper allocation between the trustees [of Eastern and Associated] of the letter of credit, and the reach of the contract between Seaboard and both Eastern and Associated" (542a). No other substantive issues have been decided.

It is generally held that so long as a principal is solvent and thus able to respond to a claim for exoneration of his surety, a surety cannot compel the principal to assert a counterclaim to exonerate the surety nor can the

surety utilize the principal's counterclaim on its own behalf when sued. United States ex rel Johnson v. Morely Construction Co., 98 F.2d 781, 789 (2d Cir. 1938). In Yale Express, the Court recognized an exception by reason of the insolvency of the principal. The exception was based on the proposition that where the principal is insolvent, the surety would have no recourse without the right of set off, and therefore, the estate of the principal would be enriched at the surety's expense. However, where, as here, the surety does have recourse, the exception recognized in Yale Express is inapplicable. The recourse available here to Seaboard, at least in part, is resort to the proceeds of the \$2,000,000 letter of credit. As the Bankruptcy Court held:

"To the extent that these proceeds are utilized in the payment of cargo claims, the estate of Eastern's trustee cannot possibly be enriched at Seaboard's expense. In short, Seaboard need not look to these insolvency proceedings to be made whole" (540a).

In Yale Express the surety had no recourse but the bankrupt estate; there were no proceeds of letters of credit; there were no voluntary payments by account debtors; and there were no security interests asserted by innocent third parties. All of these factors are present in the instant case. The presence of these factors clearly distinguishes Yale Express. It is important to note that it is not the right of account debtors to set off cargo claims against

accounts receivable owed by them to the bankrupt estate that is at issue on this appeal. A creditor may indeed exercise such a right of set off if he so chooses, subject to the equitable powers of the Bankruptcy Court. Nevertheless, the fact that Section 68(a) of the Bankruptcy Act incorporates the common law right of set off between the estate of a bankrupt and its creditors does not in any way imply that a surety has any right whatsoever to solicit the bankrupt's creditors or to inform them of their presumed right of set off where the surety has other recourse than the bankrupt estate to make itself whole.

We are essentially dealing with equitable considerations. The Bankruptcy Court held that Seaboard's equitable right to solicit set offs, insofar as such right might exist, does not ripen until the proceeds of the letter of credit are exhausted. It is only then that Seaboard has standing to make an equitable claim based upon Yale Express since it is only then that Seaboard is truly at risk. Meeker v. Halsey, 87 F.2d 299 (2d Cir. 1937).

The Yale Express case is predicated upon the principles set forth by Judge Learned Hand in United States ex rel Johnson v. Morley Construction Co., 98 F.2d 781 (2d Cir. 1938). Those principles clearly support the decisions below. As Judge Learned Hand held in the Morley case:

"If the creditor then recovers from the surety, the surety has no recourse over against the principal, but must bear the loss except for such dividends

as he may get in the insolvency proceedings. Yet having recovered from the surety and realized upon his claim, the creditor is without set-off when sued on the counterclaim by the principal's trustee or receiver, and the recovery goes to swell the estate. Had the creditor not sued the surety, he could, and of course would, have used the claim as a set-off against the counterclaim. Thus, the upshot of denying the surety a right to assert the counterclaim is to enhance the principal's estate at the expense of the surety, which is contrary to the fundamental relation between the two." 98 F.2d at 790.

For Seaboard to claim the benefits of Yale Express, prima facie, it must demonstrate that it is without recourse against Eastern; it must demonstrate that to deny its claimed right of set off would enhance Eastern's estate at Seaboard's expense. The existence of the \$2,000,000 letter of credit precludes Seaboard from meeting these initial tests. Certainly, on a motion to dismiss, the facts as pleaded must be taken as true and the Bankruptcy Court quite properly recognized that the proceeds of the letter of credit might be available to "exonerate" Seaboard, in whole or in part.

Appellant's contention that the District Court erred in holding that Yale Express was "an exception to the general rule that a surety cannot compel a solvent principal to assert a counterclaim against third party creditors nor use the principal's counterclaim when sued by such creditors" rather than the reverse is but semantic legerdemain [See, Appellant's Brief pp. 9-10]. It matters not whether Yale Express represents the "general rule" or an "exception". What is important is that a surety for an insolvent principal

must first exhaust the collateral in its possession before it may seek to encourage third parties to invoke a right of set off against its principal.

The decisions below are as noteworthy for their omissions as for their holdings. Having determined that an evidentiary hearing was required to determine whether Seaboard might even qualify in the first instance under Yale Express, both the Bankruptcy Court and the District Court declined to rule on further possible impediments to Seaboard's claim. It has not been decided whether Seaboard may set off against its liability under its bonds accounts receivable voluntarily paid by account debtors to the bankrupts. It has not been decided whether the assignment by a principal of its accounts receivable, with or without notice, defeats a surety's right to set off in the event of the principal's post-assignment insolvency. These and other related questions should not be decided by this Court on the present appeal. In the event this Court should reject the holdings of the courts below respecting the obligation of Seaboard to first exhaust the proceeds of the disputed letter of credit the case should be remanded for further findings. [See, Brief of Appellee Manufacturers Hanover Trust Company pp. 26-33].

Conclusion

The decision of the District Court from which
this appeal is taken should be affirmed in all respects.

Respectfully submitted,

ANDERSON RUSSELL KILL & OLICK, P.C.
Attorney for Thomas J. Cahill,
Trustee in Bankruptcy of Associated
Transport, Inc.
Office and Post Office Address:
630 Fifth Avenue
New York, New York 10020
(212) 397-9700

Of Counsel:

— Arthur S. Olick
Poppy B. Quattlebaum

COURT OF APPEALS
SECOND CIRCUIT

In Re EASTERN FREIGHT WAYS, INC.,
Bankrupt,
SIDNEY B. GLUCK, Trustee in Bankruptcy of
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- against -
SEABOARD SURETY COMPANY. Defendant-Appellant.
MANUFACTURERS HANOVER TRUST COMPANY et-al,
Defendants-Appellees.

Index No.

Affidavit of Personal Service

STATE OF NEW YORK, COUNTY OF

SS.:

I, Reuben A. Shearer, being duly sworn, depose and say that deponent is not a party to the action,
is over 18 years of age and resides 211 West 144th Street, New York, New York

That on the 9th day of March, 19 78 at see attached

deponent served the annexed

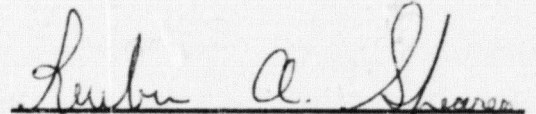
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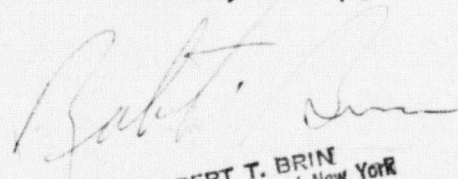
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the in this action by delivering a true copy thereof to said individual
personally. Deponent knew the person so served to be the person mentioned and described in said
papers as the herein,

Sworn to before me, this 9th
day of March, 19 78



Reuben A. Shearer



ROBERT T. BRIN
NOTARY PUBLIC, State of New York
No. 31-0418950
Qualified in New York County
Commission Expires March 30, 1979

WICKES RIDDELL BLOOMER JACOBI & MCGUIRE
59 Maiden Lane
New York, N.Y.

TELL CHESER BREITBART & LEFKOWITZ
116 John St
New York, N.Y.

BOOTH LIPTON & LIPTON
405 Park Avenue
New York, N.Y.

MARCUS & ANGEL
60 East 56th St
New York, N.Y.

KRAUSE HIRSCH & GROSS
41 East 42nd St
New York, N.Y.

WACHTELL LIPTON ROSEN & KATZ
299 Park Avenue
New York, NY.

MILBANK TWEED HADLEY & McCLOY
~~xx~~ One Chase Manhattan Plaza
New York, N.Y.

CONBOY HEWITT O'BRIEN & BOARDMAN
20 Exchange Place,
New York, N.Y.